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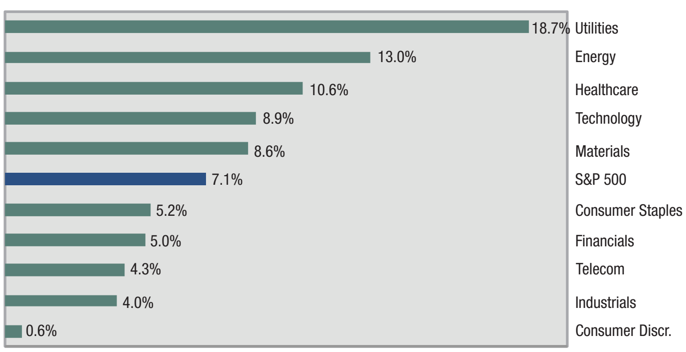
During the quarter, equity markets continued to rally, and the S&P 500 Index reached yet another all-time high in June of 1,963. After a pause in economic growth during the first quarter due to harsh winter weather, the economy is showing signs of improvement. Over the past two years, the S&P 500 has returned 50.1%, including dividends, with only minor pullbacks along the way. The Chicago Board Options Exchange Volatility Index (VIX)—a gauge of investor anxiety about market swings—sank to 10.61, its lowest reading since February 2007. We continue to position portfolios for modest economic growth, although we do expect higher volatility to reemerge at some point.

The S&P 500 Index gained 5.2% on a total return basis for the quarter and is up 7.1% for 2014. From a sector perspective, Energy led the market higher given the unrest in the Middle East. Consumer Discretionary stocks once again lagged the broader market during the quarter and are the weakest sector for the year.

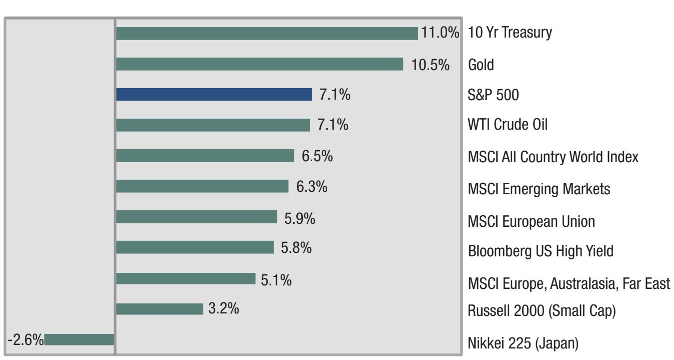
Figure 1: 2014 Performance by Sector



Source: Bloomberg. Data as of 6/30/14.

From a global perspective, most European markets have performed in line with the S&P 500 for the quarter and the year. The Japanese Nikkei has continued to lag. The emerging market index performed in line this quarter and trails the S&P slightly for the year. The Brazilian Bovespa was up 10.3% for the year, while the Shanghai Composite was down 3.9%. Oil is up 7.1% for the year, and gold is up 10.5%.

Figure 2: 2014 Performance by Category



Source: Bloomberg. Data as of 6/30/14. All returns in U.S. dollars.

The Economy Springs Back to Life

Recent statistics highlight that the harsh winter weather was the main factor in the economic pause we experienced. The economy, as defined by Gross Domestic Product (GDP), experienced a contraction in the first quarter of 2014. GDP is now expected to grow at a real rate (i.e., excluding inflation) of 3.5% in the second quarter and at a 3.1% rate for the remainder of the year. This all results in expected real GDP growth of 2.2% in 2014, down from initial forecasts of 3% or greater, but the majority of this reduction is from the first-quarter weakness. In 2015, GDP is expected to continue to grow at a 3% real rate. GDP growth running at 3% should create a positive environment for stocks. With economic growth finally accelerating, we are looking for increased revenue growth, which should translate into even higher earnings growth.

The Economic Cycle Research Institute's leading gauge index continues to show improvement in economic activity and is running at its highest rate in nearly a year. Over the years, this index has been a fairly reliable indicator. We have seen a pickup in railcar loadings and order books. Auto sales are climbing. Spending plans for summer vacations are back to seven-year highs. Commercial and industrial loan balances are up 9.4% year over year. Rising stock prices and house values have increased consumer net worth to $82 trillion, well above the $70 trillion peak of 2007. This improvement has resulted in a recovery in consumer confidence to pre-recession levels.

The biggest areas of excitement have been in manufacturing and increased capital spending. As we highlighted in our last commentary, business capital expenditures continued to show strength during the recent economic weakness. Capacity utilization has continued to increase, and in May, the length of the workweek for nonsupervisory manufacturing workers rose to 42.1 hours—the longest in over 60 years. A recent Duke/CFO Magazine Global Business Outlook Survey shows that capital spending plans are at their highest in three years. In addition to spending on technology, replacement of aging equipment, and factory expansions, we are beginning to see evidence that capital expenditure plans are broadening to include new facilities.

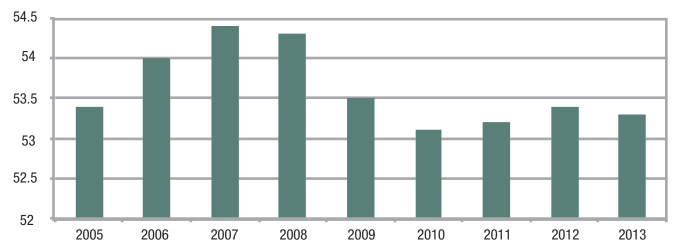
Corporate balance sheets are also being used for mergers and acquisitions (M&A). M&A activity is running close to the peak levels seen in the 2006–2007 time frame. Year-to-date, there have been over 14,300 deals with an aggregate transaction value of $2.1 trillion. Over 1,000 M&A professionals, investors, and advisors recently participated in a KPMG survey, with 63% anticipating that their U.S. clients will initiate at least one acquisition in 2014. This is an appealing strategy, given the significant cash on many corporate balance sheets, greater confidence in the overall economy, and continued low interest rates.

The Housing Recovery Slows

From the bottom, housing has had an impressive rebound. New housing starts are roughly double what they were in 2009, and prices have rebounded 30% based on national averages. The pace of homebuilding remains well below the historical trend line, which leaves plenty of room for improvement, but we are concerned that this recovery will continue at a slower pace due to certain factors. Multifamily housing starts are back to the long-term average, but newly built single-family homes remain well below. The demand for rental units remains high, and this demand has driven the growth in the multifamily space. Single-family homes have rebounded as well, although higher-end homes and investors (40% of homes in the first quarter were purchased with cash) have driven a disproportionate amount of the improvement. The weakness in the single-family housing market seems to be linked to first-time homebuyers.

According to the Mortgage Bankers Association, sales of new and existing homes in the U.S. will fall in 2014 for the first time in four years. Stricter mortgage qualification standards since the downturn are hindering younger buyers with limited money for down payments and less-than-pristine credit histories. The average FICO credit score for a conventional mortgage is now 725, down from the 2013 average of 738. Put in perspective, only about 53% of the adult population has a FICO credit score above 700 (Figure 3). In May 2014, closed home loans had an average loan-to-value ratio of 82%, which implies an 18% down payment. Higher credit score and down payment requirements have decreased the pool of available buyers.

Figure 3: Percent of Adults in the U.S. with a FICO Score Greater Than 700



Source: Barclays Research. Data as of 12/31/13.

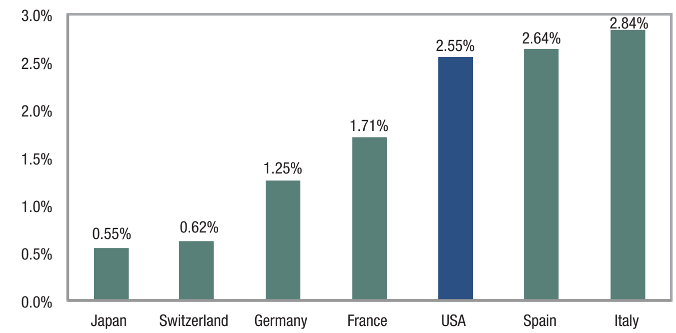
In addition, many younger buyers have large student loan balances. According to the Federal Reserve Bank of New York, the total student debt in the United States nearly tripled from $364 billion in 2004 to $966 billion in 2012, a growth rate of 13% a year. In 2004, only 27% of 25-year-olds had student debt, while in 2012 this number increased to 43%.

Lastly, we are seeing new household formations occurring at a slow pace compared to historical averages. Given the modest economic recovery and the sluggish job market, people are getting married and starting a family later in life. This has delayed their purchase of their first home. The percentage of 18- to 34-year-olds living at home has declined from the 2012 high of 31.6%, but it may take a few more years of economic growth for some of these issues to subside. The population of 18- to 34-year-olds is approximately 72 million, so a 1% improvement in this metric translates to 720,000 people no longer living at home.

U.S. Quantitative Easing on Track to End This Fall

Since the end of the Great Recession in 2009, markets have been influenced by the actions of the U.S. Federal Reserve, the European Central Bank, and the Bank of Japan. These global central banks have focused on keeping interest rates low to drive economic growth, successfully driving rates to record-low levels (Figure 4). Although U.S. rates are low by historical standards, our Treasury yields can actually be viewed as attractive, given the European and Japanese rates. During the European debt crisis in 2011–2012, Spain and Italy saw their rates soar to above 7%. With the European Central Bank determined to do whatever it takes, these yields are now comparable to ours. Japan has been in a deflationary trap for decades. Europe is currently trying to escape such an environment.

Figure 4: Select 10-Year Sovereign Bond Yields



Source: Bloomberg. Data as of 6/30/14.

From September 2012 to January 2014, the Fed purchased $85 billion of mortgage-backed securities and long-term government bonds each month. Over the first half of the year, these purchases have been reduced to $35 billion a month, and the Fed is on track to end this quantitative easing program (known as QE3) by the end of 2014. The Fed's initial goals for this program were unemployment below 6.5% and 2% inflation.

With unemployment back at respectable levels and inflation showing signs of life, the Fed can say it has accomplished its goals. In May, we finally recovered the 9 million jobs lost during the recession. This was the slowest recovery of jobs lost during a recession in history, although recent job numbers have surprised to the upside. The official unemployment rate is currently 6.3% and is expected to decline to 5.8% in 2015. An unemployment rate below 6% is often described as "full employment." The broader U-6 measure remains elevated at 12.6%, well above the pre-recession average of 8.9%. Structural aspects may keep the U-6 elevated for a while.

Modest economic growth is expected to continue in 2015, even without support from the Fed. We, along with the Fed, continue to monitor growth, employment, and inflation closely, but for now the Fed's timeline seems to be accepted by the markets.

Course of Action

We continue to position portfolios for modest economic growth. Many of the investment catalysts we had been looking for reemerged when the harsh winter ended. Housing has continued to be a bit disappointing. Volatility continues to run at low levels for now, but we do expect it to reemerge at some point.

Given the current environment, we have reviewed portfolios and reduced positions in some companies where valuation seemed full or volatility relative to the market was higher than what we were comfortable with.

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